

ClientAlert

Commercial Litigation

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Special Alert

Civil Code Reform: Rules on Conflict of Laws

On 30 September 2013, the President signed Federal Law No. 260-FZ amending Part III of the Civil Code of the Russian Federation.

The Law is the sixth set of amendments to the Russian Civil Code within the civil law reform framework. According to the Concept of Evolution of Civil Legislation ("the Concept"),¹ the aim of the amendments is to remove the legislative uncertainties and legal gaps when it comes to regulating relations involving a foreign element regarding (i) the European experience of harmonizing private international law provisions; (ii) amendments made to other sections of the Russian Civil Code and (iii) prevalent court practice.

The new provisions of the Civil Code are drafted with due regard for the provisions of the EC Regulations "Rome I" and "Rome II"² governing contractual and non-contractual obligations. In this context, the amendments resolve the following matters: (i) they introduce rules on conflict of laws applicable to certain types of relations that were not regulated in Part III of the Civil Code; (ii) they specify the scope of the application of rules on conflict of laws; and (iii) they replace the criterion of a real connection between a contract and the specific country with the broader criterion of *circumstances material* to the parties' relations and the circumstances of the case.

For the purposes of this alert, the amendments are divided into the following categories: (i) **general provisions** (determination of applicable law; correlation of general mandatory provisions and overriding mandatory provisions; circumstances concerning the essence of the parties' relations; close connection between the relations and the country; rules concerning the form of a transaction); (ii) **specific regulation of certain types of relations** (corporate; property; representation; relations involving consumer; subrogation and termination of an obligation by set-off); (iii) **contractual relations** (development of rules on conflict of laws applicable to certain types of contracts) and (iv) **non-contractual relations** (including tort obligations and pre-contractual liability).



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¹ Approved by the Resolution of the Presidential Council on Codification and Improvement of Civil Law dated 7 October 2009.

² Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I); Regulation (EC) No. 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II).

General Provisions

Determination of Applicable Law

The law applicable to the parties' relations is either determined by the parties themselves or according to statutory provisions (where the parties fail to choose or are prohibited from doing so).³

If the parties to contractual or non-contractual relations choose the law of one country but the circumstances concerning the essence of the parties' relations are connected with another country,⁴ the choice of applicable law may not affect the validity of the mandatory provisions of the latter country's law. This criterion is common for all types of relations and now is directly included in the relevant provisions of the Civil Code, – Articles 1210, 1216¹, 1217¹, 1221, 1223¹ of the Civil Code.⁵

If the contracting parties failed to choose the law applicable to their contract, such law is to be determined pursuant to the rules established under the Civil Code. If these rules refer to the law of one country but the contractual relations are *most closely connected* with another country, the law of the latter country will apply.⁶ This general principle of the closest connection with a specific country is provided for in Article 1186(2) of the Civil Code. Prior to the amendments its application was limited to the events when the law applicable to the relations could not be determined pursuant to the statute or other sources of law (e.g., custom). Now this principle applies universally, – Articles 1186, 1211 of the Civil Code.

For a compound contract, the Law expressly establishes that laws applying to separate parts of the contract may differ due to their legal nature, – Article 1211(10) of the Civil Code.

Types of Mandatory Provisions

When applying the law of one country, a Russian court may take into account the *overriding mandatory provisions*⁷ of another country that is most closely connected with the relations. These provisions aim to protect political, economic and social stability in the country. The effect of these provisions does not depend on the law governing the relations.

³ For example, obligations, arising out of unfair competition or acts restricting free competition (Article 1222(3) of the Civil Code).

⁴ Before the amendments – with which the contract is *really* connected.

⁵ Before the amendments, general provisions of the Civil Code reflected the autonomy given to contracting parties but failed to regulate non-contractual relations in this regard.

⁶ According to the Rome II Regulation, which also establishes this criteria, a manifestly closer connection with another country might be based, in particular, on a pre-existing relationship between the parties, such as a contract or tort obligations.

⁷ This term is used in the Rome I and Rome II Regulations (Articles 9 and 16 respectively). When a Russian court applies to any relations the law of another country with which such relations are most closely connected, it may consider that country's overriding mandatory provisions taking into account the consequences of their application or non-application.

However, choosing the law of one country over another cannot derogate or exclude the effect of the *mandatory provisions* of the other country's law if the contract is most closely connected with that country. This is also the case if the circumstances concerning the essence of the relations are connected with such country.⁸ Usually, the law stresses the compulsory nature of these provisions. When applying foreign law to a contract, a Russian court will take into account the mandatory provisions of the relevant country's law. In addition, the court may obligate the parties to provide information about the contents of the foreign law provisions.

In any event, a Russian court may not apply foreign law provisions which are in conflict with the public policy of Russia. The court will assess the influence of foreign law provisions on the public policy of Russia taking into account the nature of the relations involving the foreign element, – Articles 1191, 1192, 1193 of the Civil Code.

Form of Transaction

With regard to cross-border relations involving Russian companies, the Law introduces new alternative rules on conflict of laws to regulate the form of a transaction. As a general rule, the form of a transaction is subject to the national law applicable to the transaction itself. However, a transaction may not be declared invalid due to inconsistencies regarding its form if: (i) the form is consistent with the requirements of *lex loci actus* (the law of the place where the transaction occurred); or (ii) one of the parties to the transaction is a Russian individual or entity and the transaction is made abroad in line with the requirements of Russian law regarding its form. The form of a transaction is subject to Russian law if the transaction, or accrual, transfer, limitation or termination of rights related to it is subject to state registration in Russia,⁹ – Article 1209 of the Civil Code.

The Law removes the requirement to apply Russian law to cross-border transactions involving a Russian legal entity. This amendment follows from the exclusion from Article 162 of the Civil Code of the mandatory written form requirement to a cross-border transaction.¹⁰

If a company's *lex societatis* (i.e., the law of the state where a legal entity is incorporated) provides for specific requirements regarding the form of the agreement on the establishment of a legal entity or the agreement related to the exercise of the rights of a participant in a legal entity, such requirements must be complied with.

⁸ Rome I and Rome II Regulations use the term "provisions which cannot be derogated from by agreement." For example, in Russian law these would include provisions protecting consumer rights, regulating corporate relations and certain property rights.

⁹ Including transactions relating to the rights to real estate, trademarks, and inventions. However, it is not quite clear whether this requirement applies to pledges and share sale and purchase agreements.

¹⁰ The amendment to Article 162(3) of the Civil Code was made by Federal Law No. 100-FZ dated 7 May 2013.

Specific Regulation of Certain Types of Relations

Corporate

The scope of *lex societatis* now covers matters relating to the liability of a company's participants (shareholders) for its obligations. If a foreign company (e.g., an SPV) operates mostly in Russia, Russian law applies to matters regarding the liability of its participants (shareholders) unless the company's creditor chooses its *lex societatis*,¹¹ – *Article 1202 of the Civil Code*.

The choice of law applicable to an agreement on the establishment of a legal entity and an agreement related to the exercise of the rights of a participant in a legal entity¹² may not affect the mandatory provisions of the *lex societatis* of such legal entity,¹³ – *Articles 1214, 1202 of the Civil Code*. On the one hand, this provision directly allows the application of foreign law to such contracts but on the other hand, severely limits the scope of its application. This limitation should be considered, in particular, when choosing English law as the governing law to a shareholders agreement of a Russian company.

Representation

The amendments introduce detailed rules on the conflict of laws relating to representation, – *Article 1217¹ of the Civil Code*. This may arise out of a contract or a power of attorney. In the former case, the applicable law is determined according to the rules applicable to the contract. In the latter case, the rules on conflict of laws apply in the following order of priority: (i) the law chosen by a principal shall apply; (ii) if no applicable law is indicated in the power of attorney or the chosen law does not apply due to statutory requirements, the law of the representative's country of residence (principal place of business) shall apply; or (iii) if a third party did not know and should not have known about the representative's country of residence or place of business – the law of the state where the representative mainly acted in a particular case.

If a representative is empowered to enter into a real estate transaction where the accrual, transfer or termination of rights is subject to state registration and/or plead the case in a state or arbitration court, the law of the country where, respectively, the real estate is registered and where the proceedings take place shall apply.

The applicable law covers, in particular, matters relating to the existence and scope of a representative's powers, the contents and term of the power of attorney and the grounds for its termination. By default, the scope of a representative's powers includes powers to make an arbitration or jurisdiction agreement and to choose the law applicable to the transactions made by the representative on behalf of the principal.

Consumers

A consumer and its counterparty (a professional) may choose the law applicable to their contract. Despite this the mandatory provisions of the laws of the consumer's country of residence aimed at protecting consumer rights shall apply provided that the professional (i) operates in the country of the consumer's residence or by any means (including the Internet) directs its operations to such country and (ii) the contract falls within the scope of such operations of the professional, – *Article 1212 of the Civil Code*.

Property

Normally, property relations are governed by the law of the country where the property is located. The amendments establish that the parties may choose the law applicable to *movable property* without prejudice to the interests of third parties, – *Article 1206(3) of the Civil Code*. The law applicable to property rights regulates, in particular, the property's classification as movable or immovable, accrual or termination of property rights, protection of property rights, – *Article 1205¹ of the Civil Code*.

11 This provision aims to (i) prevent businessmen from establishing off-shore companies with the only purpose of conducting business in Russia instead of establishing Russian companies and (ii) encourage the removal of "corporate veils." In particular, such an alternative rule on conflict of laws will allow a creditor to refer to Russian law provisions establishing the liability of persons entitled to give the company binding instructions (including shareholders, CEOs, CEO and shareholders of a parent company), if their actions led to the company's bankruptcy. This is irrespective of the number of parent companies covering the actual beneficiary.

12 In particular, examples of this include shareholders' agreements and certain transactions relating to the disposal of shares.

13 In particular, matters related to its incorporation, reorganization and liquidation, the procedure for the acquisition of rights and assumption of obligations, internal relations, including relations of the legal entity with its participants.

Contracts

The Law clarifies the rules on conflict of laws with regard to franchise contracts, contracts on the disposal of IP rights or rights to means of identification, and licensing contracts. They are governed by (i) the law of the country where the use of the rights, IP or the means of identification is permitted or (ii) if the permission covers several countries, the law of the country where the owner is located or has its principal place of business, – *Article 1211 of the Civil Code*.

Non-Contractual Relations

Obligations arising out of tort, damages or unjust enrichment

The parties may choose the law governing their obligations arising out of a tort after the harmful events have occurred, – *Article 1223¹ of the Civil Code*. If the parties fail to determine the applicable law, generally, the law of the country where the harm was caused shall apply.¹⁴ If an obligation arising out of a tort is closely connected with the contract made between the aggrieved party and the party that inflicted the harm and is within the scope of their business, such an obligation is governed by the same law as the contract, – *Article 1219 of the Civil Code*.

Within the scope of insurance relations, the injured party may claim compensation by way of damages from the insurer directly if this is permitted by (i) the law applicable to the obligation arising out of a tort or (ii) the law applicable to the insurance contract, – *Article 1220¹ of the Civil Code*.

Usually relations arising out of damage caused by a product or service are governed by the law of the country where the person alleged to be liable for the damage (producer, supplier) is habitually resident or has its place of business. The person who sustained the damage may also choose the law of the country where he/she has its place of residence or where the product was purchased if the supplier, producer or another person said to be liable foresaw or should have foreseen the marketing of the product in the country the law of which was chosen, – *Article 1221 of the Civil Code*.

The obligations arising out of acts of unfair competition or those restricting free competition be governed by the law of the country whose market was affected or is likely to be affected by such actions.¹⁵ The law applicable to such obligations which is prescribed by this provision may not be derogated from by any agreement, – *Article 1222 of the Civil Code*.

¹⁴ This provision of the Civil Code differs from the approach established in the Rome II Regulation according to which obligations arising out of a tort are governed, typically, by the law of the country in which the damage occurs. This is irrespective of the country in which the event giving rise to the damage occurred (Article 4(1) of the Rome II Regulation).

¹⁵ Before the amendments, the Civil Code did not include provisions about potential harm to the market and did not extend rules on the conflict of laws to actions restricting free competition.

Culpa in contrahendo

According to the amendments, obligations arising out of *unfair pre-contractual* negotiations are governed by the law applicable to the contract or the law that would have been applicable to the contract had it been entered into. Where the applicable law cannot be determined according to these rules, the rules established for obligations arising out of a tort shall apply, – *Article 1222¹ of the Civil Code*.¹⁶

Subrogation and Set-Off

According to the amendments, subrogation is governed by the law applicable to the relations between the original and new creditors. However, statutory provisions governing the obligations of the debtor to the original creditor and designed to protect the debtor remain in effect regarding the relations between the new creditor and the debtor, – *Article 1216¹ of the Civil Code*.

With regard to the termination of an obligation by set-off, the Law establishes that it is governed by the law governing the relations that have given rise to the claim against which the debtor claims set-off. Where the parties have agreed to terminate the obligation by set-off, the governing law is determined according to the rules applicable to contracts, – *Article 1217² of the Civil Code*.

The provisions of the Civil Code, as amended by the Law, apply to relations that have occurred after 1 November 2013. Relations that occurred prior to this date will remain governed by the Civil Code provisions effective as of the moment of such relations' occurrence.

The Law entered into force on 1 November 2013.

¹⁶ The version of Draft Law No. 47538-6 (the Draft Civil Code) dated 27 April 2012 includes Article 434¹ introduces the obligation that a party which conducted pre-contractual negotiations in bad faith will have to pay for the damages sustained by the other party if the former party was guilty of these damages. This provision of the Draft Civil Code has been reviewed in the first reading, but the progress to date is unclear.

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